

United States Securities and Exchange Commission

Office of Inspector General Semiannual Report to Congress and Management Response

for the Period
October 1, 2000 to March 31, 2001



May 2001



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
INSPECTOR GENERAL

April 30, 2001

The Honorable Laura Unger
Acting Chairman
Securities and Exchange Commission
Washington, D.C. 20549

Dear Chairman Unger,

The attached Semiannual Report to Congress summarizes the activities of the Office of Inspector General for the six months ending March 31, 2001. It contains descriptions and accounts of the audit reports we issued during the period and summarizes the activities of our investigative and other review functions.

In accordance with the Inspector General Act of 1978, as amended, this report should be forwarded to Congress, with your comments and a separate management response by May 30, 2001.

Your continued support and cooperation, as well as that of the Commission and its staff, are greatly appreciated.

Sincerely,

Walter Stachnik
Inspector General

Attachment

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DISGORGEMENTS (AUDIT 311) ✓

Disgorgements represent ill-gotten gains (or losses avoided) resulting from individuals violating the federal securities laws. The Commission seeks disgorgement to ensure that securities law violators do not profit from their illegal activity. When appropriate, the disgorged funds are returned to the injured investors.

Disgorgements can be ordered in either administrative proceedings or civil actions, and the cases can be settled or litigated. Payment of disgorgements can be either completely or partially waived based on the defendant demonstrating an inability to pay.

In settled administrative proceedings, Enforcement may recommend, if appropriate, that the disgorgement be waived. The Commission makes the final decision. In civil actions, any settlement agreed to by the Commission must be approved by the district court.

Our audit objectives were to determine if the management controls over waivers of disgorgements and identification of investors in disgorgement plans were effective in achieving their objectives and efficient. In addition, we determined compliance with Commission Rule 201.612(c) governing whether disgorgements are paid to the injured investors or the U.S. Treasury.

We found that improvements could be made to the waiver process to achieve greater assurance that waivers were justified. The Division of Enforcement concurred and, during the audit, began taking actions with a view to improving the waiver process. It has issued written procedures relating to the waiver process, hired a firm to provide improved databases, and hired a contractor to help evaluate and make recommendations concerning its procedures.

INTEGRITY PROGRAMS (AUDIT NO. 313)

We evaluated the effectiveness of the Commission's integrity programs (*i.e.*, the ethics program in the Office of General Counsel and Personnel's staff conduct program). The review was a follow-up to two audits performed in 1996-97 (Audit Nos. 250 and 267).

Successes, obstacles, recommendations, and effectiveness ratings related to the Commission's integrity objectives were obtained through twenty-two workshops involving approximately eight per cent of Commission employees. Composite ratings were consistent with the previous audit results. Indications are that all supporting objectives are generally being implemented. We believe that, taken as a

press. The evidence obtained during our investigation failed to substantiate the allegation. We interviewed numerous staff members who had access to the nonpublic information. All denied making any unauthorized disclosures of that information. We also learned that the reporter in question had stated that the source of the information was not a Commission employee.

POST-EMPLOYMENT VIOLATION

The Office developed evidence that a former Commission staff member may have violated a federal conflict of interest statute by working for a special master in a matter the employee had worked on while employed by the Commission. We also obtained evidence that the staff member had continued to work on the matter while still employed by the Commission after accepting an offer of employment with the special master. The Department of Justice declined prosecution.

Significant Problems

DISGORGEMENTS ✓

In this reporting period, we completed an audit of disgorgements (Audit No. 311, described above). We found that improvements could be made to the waiver process to achieve greater assurance that waivers were justified.

The Division of Enforcement concurred and, during the audit, began taking actions to improve the waiver process. It has issued written procedures relating to the waiver process, hired a firm to provide improved databases, and hired a contractor to help evaluate and make recommendations concerning its procedures. We commend the Division on taking prompt action to strengthen the controls.

We intend to monitor the Division's actions to improve the waiver process.

**MANAGEMENT RESPONSE OF
THE SECURITIES AND EXCHANGE COMMISSION
ACCOMPANYING THE SEMIANNUAL REPORT OF THE INSPECTOR GENERAL
FOR THE PERIOD OCTOBER 1, 2000 THROUGH MARCH 31, 2001**

Introduction

The Semiannual Report of the Inspector General (IG) of the Securities and Exchange Commission (SEC) was submitted to the Acting Chairman on April 30, 2001 as required by the Inspector General Act of 1978, as amended. The report has been reviewed by the Chief of Staff, General Counsel, Executive Director, and Director of the Division of Enforcement. The management response is based on their views and consultation with the Acting Chairman.

The management response is divided into four sections to reflect the specific requirements listed in Section 5(b) of the Inspector General Act of 1978, as amended.

**Section I
Comments Keyed to Significant Sections of the IG Report**

A. Audit Program

During the reporting period, the IG issued seven audit reports, one investigative memoranda on management issues, and one audit memoranda. Management concurred with most of the findings and recommendations in the IG's reports.

In addition to audits performed by the agency's IG, the General Accounting Office (GAO) actively reviewed program and administrative functions of the SEC. A complete listing of all GAO audit activity involving the SEC is attached as Appendix A.

B. Response to Significant Problems ✓

The IG reported the disgorgement waiver process as a significant problem. SEC management concurred with the IG's audit recommendations and began taking actions to improve the disgorgement waiver process. For example, management has issued written procedures relating to the waiver process, hired a firm to provide improved databases, and hired a contractor to help evaluate and make recommendations concerning its procedures.

C. Response to Significant Problems Previously Identified

The IG's Semiannual Report discusses three significant problems that were previously identified: (1) Sensitive Information, (2) Collection of Filing Fees, and (3) Information Resources Management. The SEC continues to work aggressively to strengthen controls in these areas.



Office of Inspector General

Disgorgements

January 11, 2001

Audit Report No. 311

MEMORANDUM

January 11, 2001

To: Jack Katz
Jim McConnell
Dick Walker
From: Walter Stachnik *W Stachnik*
Re: Disgorgements (Audit No. 311)

Attached is our audit report on Disgorgements. Your comments on the draft report have been incorporated as appropriate.

The courtesy and cooperation of you and your staff during this audit are appreciated.

Attachment

cc: Regional Directors
District Administrators
Tracey Aronson
Margaret Carpenter
James Clarkson
Steve Cutler
Dave Fielder
Dave Levine
Thomas McCool
Margaret McFarland
Joan McKown
Darlene Pryor
Laurie Stegman
Laurie Stewart

DISGORGEMENTS

EXECUTIVE SUMMARY

Our audit objectives were to determine if the management controls over waivers of disgorgements and identification of investors in disgorgement plans were effective in achieving their objectives and efficient. In addition, we determined compliance with Commission Rule 201.612(c) governing whether disgorgements are paid to the injured investors or the U.S. Treasury.

We found that improvements could be made to the waiver process to achieve greater assurance that waivers were justified. The Division of Enforcement concurred and, during the audit, began taking actions with a view to improving the waiver process. It has issued written procedures relating to the waiver process, hired a firm to provide improved databases, and hired a contractor to help evaluate and make recommendations concerning its procedures. We commend the Division of Enforcement for its prompt action.

While Enforcement is generally complying with Rule 201.612(c), additional guidance was needed concerning insider trading cases. Additional guidance was also needed on the supervisory review of disgorgement plans resulting from administrative proceedings. During the audit, the Division of Enforcement issued the additional guidance.

SCOPE AND OBJECTIVES

The audit objectives were to determine if: (1) the procedures used by Enforcement obtained reasonable assurance that the defendant (or respondent) demonstrated an inability to pay the disgorgement order, resulting in a waiver of disgorgement; (2) the staff complied with Commission Rule 201.612(c); and (3) the management controls identified injured investors for inclusion in disgorgement plans resulting from administrative proceedings. We did not review the Commission's collection process for disgorgements¹ or the Disgorgement Payment Tracking System maintained by the Office of the Secretary.

Among other procedures, we interviewed or surveyed staff at the Commission and other federal agencies, reviewed supporting documentation and investigative case files, conducted research on available methods to search for hidden assets, and

¹ The Division of Enforcement plans to have the contractor review the disgorgement collection process, as well as the waiver process.

analyzed quantitative data on disgorgements. We reduced the scope of our audit work on disgorgement waivers because, during the audit, the Division of Enforcement concurred that improvements could be made and they promptly began taking actions with a view to improving the waiver process.

The audit was performed in accordance with generally accepted government auditing standards from November 1999 to June 2000.

BACKGROUND

Disgorgement represents ill-gotten gains (or losses avoided) resulting from individuals violating the federal securities laws. The Commission seeks disgorgement to ensure that securities law violators do not profit from their illegal activity. When appropriate, the disgorged funds are returned to the injured investors.

Disgorgements can be ordered in either administrative proceedings or civil actions, and the cases can be settled or litigated. Payment of disgorgement can be either completely or partially waived based on the defendant demonstrating an inability to pay.

In settled administrative proceedings, Enforcement may recommend, if appropriate, that the disgorgement be waived. The Commission makes the final decision. In civil actions, any settlement agreed to by the Commission must be approved by the district court.

In litigated administrative proceedings and civil actions, the judge makes the determination regarding the waiver of disgorgement. The defendant's alleged inability to pay can be raised during the trial, at the sanction phase, or afterwards. The judge may ask the Enforcement staff to submit evidence, if Enforcement believes that the defendant has an ability to pay.

During the waiver process, the Enforcement staff ordinarily requests sworn financial statements and tax returns from the defendant. It may also request other information and documents, as deemed necessary, to evaluate the ability to pay (CFR 201.630(b)). If the Commission approves the waiver, the disgorgement will be ordered and payment will be simultaneously waived.

If the injured investors are going to be compensated, a disgorgement plan is prepared. The disgorgement plan identifies the injured investors to whom restitution should be made. In administrative proceedings, an attorney in Enforcement normally prepares the plan and acts as the receiver. In civil actions, Enforcement provides guidance as to the identity of the injured investors, and the district court judge appoints the receiver, who is normally an attorney practicing within the court's jurisdiction.

Collected disgorged funds in administrative proceedings are received by the Commission's Office of the Comptroller. In civil actions, the funds are typically paid to the district court. Penalties will not be ordered if the defendant demonstrates an

inability to pay, because they cannot be waived. Although, the order will discuss that a penalty was appropriate.

In fiscal year 1999, the Commission ordered disgorgements (including pre-judgment and post-judgment interest) of approximately \$656 million and waived approximately \$179.5 million.

AUDIT RESULTS

WAIVER PROCESS BEING IMPROVED

During the survey phase of the audit, we reviewed the case files for some recent disgorgement waivers, which were granted. We also interviewed knowledgeable Enforcement staff who worked on disgorgement waivers. The purpose was to identify the procedures being used by Enforcement in order to evaluate waiver requests. Based on our review, we concluded that the waiver process could be improved to enhance the search for any assets hidden (*i.e.*, assets not reported in the sworn financial statements) by the defendant.

We identified several techniques used by professionals in private industry seeking to identify hidden assets that may be applicable to the processing of disgorgement waiver requests. These improvements included the increased use of databases, use of additional analytical procedures, and the use of field investigation techniques.

We discussed our preliminary conclusions based on the audit survey with the Division of Enforcement, and indicated that we intended to recommend that these techniques be incorporated in the waiver process. The Division of Enforcement concurred with our assessment, and began taking action with a view to improving the waiver process. Accordingly, we reduced the scope of the audit, since extensive testing appeared unnecessary in light of the planned actions.

They have issued written procedures relating to the waiver process, hired a firm to provide improved databases, and hired a contractor to help evaluate and make recommendations concerning its procedures. The guidelines, which we reviewed, incorporated our suggested improvements. The Division of Enforcement's actions appear appropriate to improve the waiver process. We intend to conduct a follow-up audit to review the implementation of these actions.

Recommendation A

The Division of Enforcement should implement its planned improvements, as discussed above. It should also determine the best organizational structure for effectively reviewing disgorgement waiver requests (*e.g.*, hiring a contractor to review waiver requests, establish a separate Enforcement unit, or a unit outside Enforcement with specialized expertise for this purpose).

Recommendation B

The Division of Enforcement should review the contractor's findings ² and consider whether reviewing additional selected waivers previously approved would achieve Commission Enforcement policy objectives in a cost effective manner. The Division may wish to consult with the contractor and the Office of Economic Analysis in making that determination.

PAYMENT METHOD GENERALLY COMPLIED WITH COMMISSION RULE 201.612(C)

After the disgorged funds from all defendants in a case have been collected and the related litigation is completed, the funds can either be paid to the U.S. Treasury or distributed to the injured investors. According to Commission Rule 201.612(c):

*"When, in the opinion of the Commission or the hearing officer, the cost of administering a plan of disgorgement relative to the value of the available disgorgement funds and the number of potential claimants would not justify distribution of the disgorgement funds to injured investors, the plan may provide that the funds shall be paid directly to the general fund of the United States Treasury."*³

For administrative proceedings, the Commission routinely defers to the judgment of officials in Enforcement on this payment issue. In civil actions, the Enforcement staff recommends to the court whether to distribute disgorged funds to investors, and identifies which investors were injured.

We reviewed a sample of 19 cases in which disgorgement was made. The sample represented all disgorgements in which the (1) disgorgement order was issued in fiscal year 1998, (2) the disgorgement amount collected for the case exceeded \$50,000, and (3) collection and litigation efforts for the case were complete.

Generally, we found that the decision reached on the payment method (to Treasury or to injured investors) appeared reasonable and in accordance with Commission Rule 201.612(c). However, we did find that there was a lack of understanding among the staff attorneys as to when a distribution plan is appropriate for insider trading cases. Additional staff guidance on this issue appears appropriate.

² The contractor is going to review ten waivers approved by the Commission in order to assist it in evaluating the newly issued procedures and recommending any additional procedures. The review of these ten previous waivers will provide the Division of Enforcement with some insight as to whether the defendants in these matters may have submitted false and/or misleading financial statements (e.g., because they had hidden assets) upon which the Division of Enforcement relied on in recommending the waivers.

³ This rule was implemented when the Commission obtained the authority (through the Securities Enforcement Remedies and Penny Stock Reform Act of 1990) to order disgorgements in Administrative Proceedings. We also used this guidance for reviewing civil actions because we are unaware of any guidance for disgorgements resulting from civil actions.

Recommendation C

The Division of Enforcement should issue guidance to its staff, clarifying in what circumstances disgorgement in insider trading cases should be distributed to investors.

During the audit, the Division of Enforcement issued the guidance, described in the recommendation.

STRENGTHEN MANAGEMENT CONTROLS OVER DISGORGEMENT PLANS

To evaluate the management controls over identifying injured investors, we reviewed five disgorgement plans. Our sample included all five disgorgement plans in 1998 and 1999 that resulted from administrative proceedings in which funds had been disbursed (controls over disgorgement plans resulting from civil actions are the responsibility of the receiver who is appointed by the district court).

Enforcement staff involved in these cases told us that they were readily able to identify the injured investors from the violator's books and records. However, it was unclear (partly because of staff turnover) to what extent supervisors reviewed the disgorgement plans. Supervisory review is important to ensure accuracy.

Recommendation D

The Division of Enforcement should issue guidance to its staff on the supervisory review of disgorgement plans resulting from administrative proceedings, including any documentation requirements.

During the audit, the Division of Enforcement issued the guidance, described in the recommendation.